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Directors' powers and the proper purposes rule

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Abstract: This article analyses recent developments in the proper purposes rule. In *Eclairs Group Ltd and another v JKX Oil and Gas plc* [2015] UKSC 71 the UK Supreme Court revisited the proper purposes rule in the context of directors' power to impose restrictions on voting and other rights attaching to shares. The decision is notable for two aspects. First, it clarifies that the exercise of a power that does not meet the proper purposes test cannot be defended on the ground that it promotes the long-term success of the company. Second, it proposes a new test for determining the principal purpose for which a power was exercised. It is submitted that both aspects are positive developments of the law governing directors' powers.

Keywords: fraud on a power; proper purposes rule; constitutional allocation of powers; the business judgment rule

The proper purposes doctrine is a cornerstone of the law of legal powers. The donee of a power must exercise it only for the purposes for which it was conferred by the donor. The rule is an application of the broader equitable doctrine of fraud on a power, which was developed in the context of trustees' powers of appointment.¹ Over time, this doctrine was extended to other power holders, such as mortgagees,² liquidators³ or insurers.⁴ For company directors, the proper purposes rule is codified in s.171(b) of Companies Act 2006 (the Act), which states that directors must 'only exercise powers for the purposes for which they are conferred.'

¹ *Vatcher v Paull* [1914-15] All ER Rep 609, [1915] AC 372, 378; *Topham v Duke of Portland* (1869) LR 5 Ch App 40, 11 WR 507; *Aleyn v Belchier* (1758) 1 Eden 132, 28 ER 634.

² *Robertson v Norris* (1858) 1 Gift 421, (1858) 65 ER 983.

³ *Re Wreck Recovery & Salvage Co.* (1880) 15 Ch D 353, [1874-80] All ER Rep 755.

⁴ *Groom v Crocker*, [1939] 1 K.B. 194; [1938] 2 All ER 394.

Directors, like other fiduciaries entrusted with the management of another's interests, enjoy a wide degree of authority that enables them to apply their business judgment in complex and rapidly changing contexts. Their decisions are often driven by multiple objectives and have complex effects, proximate and remote. For example, a director may exercise the power to issue new shares for the proximate and dominant objective of raising new capital. At the same time, he may be motivated by a secondary, long-term objective to use the new capital to finance a business expansion that will increase his personal reputation and job security. An incidental consequence of this decision is that the voting power of the majority shareholder is diluted. Is this exercise of power liable to be set aside for having an improper purpose? When a director is motivated by multiple purposes, all influential in different degrees, but some proper and some improper, the validity of the decision depends on the test used to determine the principal purpose. What is the appropriate test for identifying the principal purpose? When improper purposes exist, is the decision liable to be set aside although the director exercised the power in complete good faith, with the sole aim of protecting the company's interests?

There are no simple, straightforward answers to these questions. On the contrary, the proper purpose doctrine is 'the least discussed and least well understood of the fiduciary obligations affecting a director.'⁵ In *Eclairs Group Ltd and another v JKX Oil and Gas plc*⁶ the UK Supreme Court addressed these questions in the context of directors' power to impose restrictions on voting and other rights attaching to shares. The decision is notable for two main insights. First, it clarifies the relation between the proper purposes rule (s.171(b) of the Act) and the duty to promote the success of the company (s.172 of the Act). The exercise of a power that does not meet the proper purposes test cannot be defended on the ground that it promotes the long-term success of the company.

Second, it proposes, in *obiter*, a new test for determining the principal purpose for which a power was exercised (also referred to as primary, dominant, substantial purpose). Under the current test, when multiple purposes exist, the purpose that weighted the heaviest in directors' minds when they exercised the power is regarded as the principal purpose.⁷ This test has been criticised as giving the courts a power to make value judgments and to second-guess

⁵ Richard Nolan, "The Proper Purpose Doctrine and Company Directors" in Barry Rider, ed, *The Realm of Company Law* (Kluwer Law International, 1997) 1, 1.

⁶ [2015] UKSC 71, [2016] 1 BCLC 1

⁷ *Ibid*, [19]; *Howard Smith Ltd v Ampol Petroleum* [1974] UKPC 3, [1974] 1 All ER 1126, 1131.

directors' business decisions.⁸ It has also been argued that the uncertainty that this test creates for company directors outweighs the flexibility that it affords to the courts.⁹

Under the new test, when multiple purposes exist, the principal purpose is the one but for whose presence the power would not have been exercised as it was (the 'but-for' test). *Eclairs*, it is submitted, is a positive development in the law governing directors' decisions. The but-for test offers a more practical approach to determining the principal purpose, compared to the current test. It also increases the certainty and predictability of directors' exercise of powers. Under the but-for test, a court allows a decision to stand if it determines that the directors would have adopted the same decision, had they placed appropriate focus on the permissible purpose. Nevertheless, this area of law remains uncertain until the but-for test is confirmed by the *ratio decidendi* of a Supreme Court decision.

The facts

The facts can be stated briefly. JKC Oil & Gas Plc was a struggling company. The value of its shares fell to historically low levels, which made it vulnerable to hostile takeovers.¹⁰ The JKC directors feared that two of the company's minority shareholders, Eclairs Group Ltd and Glengary Overseas Ltd, planned to acquire control. The directors issued disclosure notices addressed to the two minority shareholders and their controllers, requesting information about the beneficial ownership of their shares and any existing agreements or arrangements relating to such shares.¹¹ Eclairs and Glengary responded promptly. They admitted the existence of interests in JKC shares, but denied any agreements or arrangements.¹² The JKC directors considered that the responses were inadequate, because they believed that there were undisclosed secret understandings between the addressees. Consequently, they exercised their constitutional power to issue restriction notices in relation to the shares held by Eclairs and Glengary, suspending their voting rights and restricting their transfer.¹³ Eclairs and Glengary challenged the board's exercise of the power to issue restrictive notices, arguing that it had an improper purpose. The board's real purpose, the minority shareholders argued, was not to

⁸ Jean du Plessis, "Directors' Duty to Use Their Powers for Proper or Permissible Purposes" (2004) 16 *South African Mercantile Law Journal* 308, 308; Len Sealy, "'Bona Fides' and 'Proper Purposes' in Corporate Decisions" (1989) 15 *Monash University Law Review* 265, 276-277.

⁹ John H. Farrar, "Abuse of Powers by Directors" (1974) 33 *Cambridge Law Journal* 221 at 223

¹⁰ *Eclairs Group Ltd and another v JKC Oil and Gas plc* [2015] UKSC 71, [2016] 1 BCLC 1, [3].

¹¹ *Ibid*, [5].

¹² *Ibid*.

¹³ *Ibid*, [7].

obtain the alleged undisclosed information, but to prevent them from voting against the resolutions that the board proposed at the forthcoming annual general shareholders meeting (AGM).¹⁴

The court decisions

The minority shareholders were successful at first instance.¹⁵ Mann J found that the principal purpose of the restriction notice was to disenfranchise Eclairs and Glengary, in order to maximise the prospects of passing the AGM resolutions.¹⁶ Although the directors had reasonable cause to believe that the responses to the disclosure notices were incomplete, and although they acted in what they honestly believed to be the best long-term interests of JKX, the power was exercised for an impermissible purpose.¹⁷ Writing in *obiter*, Mann J went on to investigate what would have happened, had the directors confined themselves to the proper purpose of imposing restrictions as a means to compel the production of information. He found it ‘virtually inevitable’ that that the directors would have reached the same decision and imposed the same restrictions.¹⁸ The crucial difference between what had happened and the hypothetical scenario was that in the latter case the imposition of the restrictions would have been primarily motivated by a desire to induce the provision of information, coupled with a perception that it would be appropriate to prevent the minority shareholders from voting while they were withholding information that was relevant to the directors and the other shareholders. In the hypothetical case, the directors’ strong views about the dangers that the raiders posed to JKX’s long term interests would have been a secondary consideration, and would not have affected the propriety of their decision. Since this hypothetical case was not pleaded, Mann J did not allow JKX to pursue it.¹⁹ Consequently, he ruled that the board’s exercise of power was voidable and should be set aside.

JKX was successful on appeal.²⁰ Sir Robin Jacob and Longmore LJ allowed the appeal, arguing that the proper purposes doctrine was not applicable to the directors’ power to disenfranchise shareholders. In their view, neither the statutory provisions of the Act, nor

¹⁴ *Ibid*, [8].

¹⁵ *Eclairs Group Ltd and another v JKX Oil and Gas plc and others* [2013] EWHC 2631 (Ch), [2014] 1 BCLC 202.

¹⁶ *Ibid*, [200].

¹⁷ *Ibid*, [262].

¹⁸ *Ibid*, [237].

¹⁹ *Ibid*, [243].

²⁰ *Eclairs Group Ltd and another v JKX Oil & Gas plc and others* [2014] EWCA Civ 640, [2014] 2 BCLC 164.

JKX's articles of association limited the power to impose restrictions to the sole purpose of obtaining the requested information.²¹ Shareholders' failure to comply with a disclosure notice gives the directors a right to impose restrictions for any purpose which they in good faith consider to promote the success of the company, including influencing the outcome of a forthcoming AGM. In the majority's view, to restrict the power only to the purpose of obtaining information would mean to emasculate it and subvert the board's constitutional authority to act in the best interests of the company.²²

Eclairs appealed. All five justices of the Supreme Court agreed to allow the appeal and restore Mann J's decision but expressed different views on the proper course of action for identifying the principal purpose of a power.

Lord Sumption wrote the reasons for allowing the appeal. He pointed out that the Court of Appeal erred in its interpretation of the purposes for which the power to impose restriction notices was granted. When the instrument granting the power is silent, the range of proper purposes is determined by looking at the context in which the power was granted and at its effects.²³ In Lord Sumption's view, the power to impose restriction notices has three closely related purposes: to induce the shareholder to comply with a disclosure notice, to protect the company and its shareholders against having to decide in the absence of all relevant information, and to impose a sanction on the addressee of a disclosure notice for as long as the non-compliance persists.²⁴ None of these purposes was principal or dominant when the JKX board decided to restrict the minority shareholders' rights. As the trial court established, the board's main objective was to influence the outcome of the forthcoming AGM. Consequently, exercise of the power should be set aside, as per Mann J's decision.²⁵

In determining the principal purpose for which the JKX board exercised the power to issue restrictive notices, Lord Sumption proposed a novel test. Drawing on British and Australian precedents,²⁶ he argued that, when a decision to exercise a fiduciary power is motivated by a mix of proper and improper purposes, the principal (or primary, dominant, substantial) purpose should be identified using a causal but-for test, instead of the weightiest purpose test. The

²¹ *Ibid*, [138], [141].

²² *Ibid*, [137], [142].

²³ *Eclairs Group Ltd and another v JKX Oil and Gas plc* [2015] UKSC 71; [2016] 1 BCLC 1, [31].

²⁴ *Ibid*, [32].

²⁵ *Ibid*, [43], [44].

²⁶ *Mills v Mills* [1938] HCA 4, (1938) 60 CLR 150; *Whitehouse & Anor v Carlton Hotels Pty Ltd* (1987) 61 ACLR 715; *Howard Smith Ltd v Ampol Petroleum* [1974] UKPC 3, [1974] 1 All ER 1126.

decision will be invalid if the improper purpose is causative, in the sense that, but for its presence, the power would not have been exercised.²⁷

Lord Hodge agreed unconditionally with the but-for test, while Lord Clarke and Lord Mance (with whom Lord Neuberger agreed) declined to express a conclusive opinion.²⁸ In their view, determining the test to be applied where multiple purposes exist requires further debate. Lord Mance expressed ‘sympathy’ with Lord Sumption’s test, but remained sceptical about the rationales for adopting it.²⁹ He questioned Lord Sumption’s interpretation of the British and Australian precedents, and disagreed that a causal approach has practical advantages over the weightiest purpose approach.³⁰

Analysis

Lord Sumption’s approach to determining the range of permissible purposes of a power has strong doctrinal and judicial support. In *Hogg v Cramphorn Ltd*, Buckley J stated that directors’ belief that what the majority shareholders intended to do was detrimental to the interests of the company is irrelevant to the question of proper purposes.³¹ More recently, in *Dryburgh v Scotts Media Tax Ltd*, Lord Glennie examined the relevant precedents and concluded that directors are not allowed to rely on the duty to act in the best interests of the company when they used a power for a collateral purpose.³² The Court of Appeal’s view on this matter, however, has significant intellectual traction as well. The range of permissible purposes of a power may only rarely be determined as neatly as the Supreme Court did in *Eclairs*. In UK company law, the company’s constitution is essential for determining the distribution of decision-making powers between directors and shareholders. The constitution, however, is seldom the product of detailed debates about the purpose of a specific power. Most provisions are either incorporated from the Model Articles, or grant directors a wide degree of authority. Consequently, in most cases, it is impossible to have a clear understanding of all permissible purposes of a power.³³ This has led some authors to argue that the proper purposes rule has no place in corporate law, since the test for identifying the range of permissible

²⁷ *Eclairs Group Ltd and another v JKX Oil and Gas plc* [2015] UKSC 71; [2016] 1 BCLC 1, [19]-[22].

²⁸ *Ibid*, [46]-[55].

²⁹ *Ibid*, [53].

³⁰ *Ibid*.

³¹ [1967] Ch 254; [1966] 3 All E. 420, 428.

³² [2011] CSOH 147, [92].

³³ *Howard Smith Ltd v Ampol Petroleum* [1974] UKPC 3, [1974] 1 All ER 1126, 1134.

purposes and the test for determining whether directors acted *bona fide* in what they consider to be in the interests of the company are virtually identical.³⁴

The Court of Appeal's approach is correct in emphasising the difficulties associated with determining the objective limits of a directors' power, but overlooks an essential role that the proper purposes rule plays in company law: maintaining the constitutional separation of powers between the board and the shareholder body. The two main contexts in which the proper purposes doctrine has been invoked in company law are situations in which the board has strong incentives to usurp shareholders' authority. First, when the control of the company is disputed between competing groups, there is a real danger that the board will use its powers to maintain the status quo or to favour a particular group.³⁵ Second, boards may be tempted to use their powers to undermine the shareholder franchise, by influencing the outcome of a general meeting.³⁶ The proper purposes doctrine acts as a safety net for the constitutional distribution of powers, by invalidating decisions that, albeit motivated by a genuine desire to promote the long-term success of the company, infringe shareholders' authority.

The second key insight of the Supreme Court decision is the but-for test proposed by Lord Sumption for determining the principal purpose. This test, Lord Sumption argued, has several advantages over the more conventional test, which equates the principal purpose with the weightiest purpose, i.e. the purpose about which directors felt the strongest.

First, the former test avoids the practical difficulties of the latter. When multiple concurrent purposes exist, it is difficult and impractical to weigh them and rank them in order of intensity.³⁷ Second, as a matter of principle and policy, a fiduciary power must be exercised only for the purposes for which it was given. When, as it is often the case, mixed purposes exist, the law allows the decision to stand as long as it has not caused injustice to the interests it seeks to protect. When injustice occurred, the evaluation of the decision inevitably moves 'in the realm of causation'.³⁸ If without the improper purpose the impugned decision would not have been adopted, then it would be irrational to allow the decision to stand simply because the directors also had proper and weightier considerations in mind. Conversely, if both proper and

³⁴ Ross Grantham, "The Powers of Company Directors and the Proper Purpose Doctrine" (1994-1995) 5 *Kings College Law Journal* 16, 17; Saul Fridman, "An Analysis of the Proper Purpose Rule" (1998) 10 *Bond Law Review* 164, 182.

³⁵ See *Hogg v Cramphorn Ltd* [1967] Ch 254, [1966] 3 All ER 420.

³⁶ See *Piercy v S Mills & Co* [1920] 1 Ch 77, [1918-19] All ER Rep 313.

³⁷ *Ibid*, [20].

³⁸ *Ibid*, [21].

improper motives existed, and the power would still have been exercised in the absence of the improper ones, there is no compelling reason to set the decision aside.³⁹

Lord Sumption relied on *Whitehouse v Carlton Hotel Pty Ltd*⁴⁰ as support for the causal test. Although the but-for test analysis was *obiter* in *Whitehouse*, numerous other Australian courts have applied this test.⁴¹ The test was also applied by British courts, mostly in the context of trustees' powers of appointment.⁴² Furthermore, the but-for test has doctrinal support. After reviewing a significant number of authorities on the application of the proper purposes rule, the leading treatise on legal powers concludes that 'the "but for" test seems more appropriate and more consistent with the reported cases.'⁴³

Lord Sumption's reasons for advocating a causal test, it is submitted, are persuasive. The courts have repeatedly emphasised that identifying the entire range of proximate and remote purposes that animated the exercise of a power, and ranking them in order of intensity, pose phenomenal obstacles.⁴⁴ Moreover, in many cases where multiple purposes exist, not even the decision maker is able to identify which purpose was the most influential in his mind. A court's determination of the dominant motive in this case risks being artificial or arbitrary.⁴⁵ The causal test avoids some of these difficulties by eliminating the need to evaluate and compare the intensities of all concurrent purposes.

Second, allowing the courts to uphold or invalidate a decision based on what they consider to be the most influential purpose in directors' minds gives judges a greater scope to interfere with directors' business judgment.⁴⁶ Although the danger of misusing the powers to usurp the constitutional balance of authority is real, the proper purposes rule must not unduly restrict directors' discretion. The courts must be careful not to intervene in the company's internal management when reviewing the business decisions of directors. It is well established, both in UK company law and elsewhere, that courts will not review the commercial merits of directors' decisions.⁴⁷ Consequently, the test for determining if a power was exercised for

³⁹ *Ibid.*

⁴⁰ (1987) 61 ACLR 715, 721.

⁴¹ See *McGuire v Ralph McKay Ltd* (1987) 5 ACLC 891; *Permanent Building Society v Wheeler* (1994) 14 ACSR 109

⁴² See *Re Turner's Settled Estates* (1884) 28 Ch D 205; 52 LT 70; *Cooper v Cooper* (1896) LR 8 Eq 312.

⁴³ Geraint Thomas, *Thomas on Powers* (Oxford University Press, 2012) 454

⁴⁴ *Grant v John Grant & sons Ltd* (1950) 82 CLR 1, 46; *Mills v Mills* [1938] HCA 4, (1938) 60 CLR 150, 185.

⁴⁵ David Bennett, "The Ascertainment of Purpose when Bona Fides Are in Issue: Some Logical Problems" (1989) 12 *Sydney Law Review* 5, 7; Andrew Keay, *Directors' Duties* (Jordans, 2014), 101-102.

⁴⁶ Len Sealy, "'Bona Fides' and 'Proper Purposes' in Corporate Decisions" (1989) 15 *Monash University Law Review* 265, 277.

⁴⁷ *Carlen v Drury* (1812) 1 Ves & Bea 154, 158; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483, 493; *Howard Smith Ltd v Ampol Petroleum* [1974] UKPC 3, [1974] 1 All ER 1126, 1131.

proper purposes must balance the need to protect the constitutional allocation of powers inside the company with the need to shield directors' decision making authority from judicial second-guessing. Moreover, allowing a decision to stand when it can be proven that the same result would have been achieved if the improper purposes had been ignored enhances the certainty and finality of directors' decisions. For listed companies, such as JKX, increasing the certainty of boards' decisions is a matter of both private and public interests. Not only it allows existing members to rely on directors' decisions, but also it promotes stability and proper functioning of the securities market.

Conclusion

For the most part, the distinction between the weightiest and the causative tests for determining the principal purpose of the exercise of a power may be irrelevant. The weightiest purpose will usually be causative as well. When the two tests lead to different results, as in *Eclairs*, identifying the most suitable test becomes a pressing concern. Lord Sumption's interpretation of the proper purposes rule has strong intellectual appeal. Its main advantage is a greater protection of directors' business judgment. The but-for test promises to reduce the scope of judicial intervention and second-guessing of business decisions, and to increase the chances of a decision motivated by mixed purposes to withstand judicial scrutiny. The Supreme Court's decision in *Eclairs*, however, could only suggest these developments in general terms. The trial judge investigated only tentatively the causal link between the improper purpose of aiming to influence the outcome of the AGM and the exercise of the power to impose restrictions, and refused to allow any point on causation to be raised. It is to be hoped that the Supreme Court will follow Lord Sumption and adopt the but-for test in the future.